



Jemena Electricity Networks (Vic) Ltd

2026-31 Electricity Distribution Price Review - Revised Regulatory Proposal

Attachment 06-05

Response to the AER's draft decision - Insurance operating
expenditure



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Abbreviations

AER	Australian Energy Regulator
current regulatory period	The regulatory control period covering 1 Jul 2021 to 30 Jun 2026
DNSP	Distribution Network Service Providers
EBSS	Efficiency Benefit Sharing Scheme
JEN	Jemena Electricity Networks (Vic) Ltd
NEL	National Electricity Law
NEO	National Electricity Objective
NER	National Electricity Rules
next regulatory period	The regulatory control period covering 1 Jul 2026 to 30 Jun 2031
previous regulatory period	The regulatory control period covering 1 Jan 2016 to 31 Dec 2020
Victorian DNSPs	AusNet, JEN, Powercor and United Energy

Overview

This document sets out our response to the Australian Energy Regulator's (**AER**) draft decision on Jemena Electricity Networks (Vic) Ltd's (**JEN**) insurance costs across the 2021-26 (**current**) and 2026-31 (**next**) regulatory periods.

In its draft decision, the AER proposed three adjustments relating to our insurance premiums, as follows:

- a non-recurrent efficiency gain is included in base year operating expenditure, which increases our operating expenditure allowance in each year of the next regulatory period in an amount equal to our underspend on insurance premiums in the base year (i.e. the premium allowance in the base year less actual insurance premiums);
- a negative step change adjustment, calculated as the difference between the premium allowance and actual premium in the final year, that decreases our operating expenditure allowance in each year of the next regulatory period; and
- an adjustment to the calculation of the Efficiency Benefit Sharing Scheme (**EBSS**) carryover amounts arising from the application of the EBSS during the current regulatory period to reflect the non-recurrent efficiency gain adjustment made to base operating expenditure.

We understand that these adjustments are intended by the AER to:

- ensure the AER's alternative estimate of total forecast operating expenditure satisfies the operating expenditure criteria set out in clause 6.5.6(c) of the National Electricity Rules (**NER**), by setting a forecast operating expenditure allowance equal to that required by a prudent operator;
- remove the expected difference between actual and forecast insurance premiums in the final year, so ensuring this difference does not carry over into the forecast operating expenditure for the next regulatory period; and
- return all the 2021 – 2026 insurance premium underspends to customers through EBSS decrements 6 years later, in a manner consistent with all insurance underspends in 2021 - 2026 being non-recurrent efficiency gains, while ensuring we retain our share of insurance premiums underspends in the form of the time value of holding the underspends for 6 years.

Our revised regulatory proposal does not accept the AER's draft decision in respect of insurance premiums. Rather, we retain the approach to determining forecast operating expenditure in our initial regulatory proposal through a standard base-step-trend approach, and remove the adjustment of non-recurrent efficiency gain in both operating expenditure and EBSS.

This is because:

1. The legal opinion we received considers that the approach set out in the AER's draft decision is unlawful. We refer to a legal opinion provided by the Hon. John Middleton AM KC, Senior Advisor at DLA Piper and former judge of the Federal Court and President of the Australian Competition Tribunal, in which he concludes that the AER's draft decision is contrary to law, as follows¹:
 - a) The AER's draft decision, which treats our underspend on insurance premiums as a non-recurrent efficiency gain, is not authorised by any statutory provision. In other words, the AER does not have the power to make the adjustments set out in its draft decision.
 - b) The AER's draft decision, which effects a clawback of our underspend on insurance premiums in the current regulatory period, is contrary to the scheme of Chapter 6 of the NER.
 - c) The AER's draft decision contravenes section 16(1) of the National Electricity Law (**NEL**). The AER is not exercising its economic regulatory function or power in a manner that will or is likely to contribute to the achievement of the National Electricity Objective (**NEO**).

¹ DLA Piper, JEN - RP - Att 06-06 John Middleton Legal Opinion for Victorian DNSP Insurance Opex - 20251128

- d) The reasoning of, and rationale for, the AER's draft decisions are unreasonable.
2. The approach set out in the AER's draft decision creates perverse incentives for Distribution Network Service Providers (**DNSP**), and undermines the objectives and intent of the NEL/NER economic regulatory regime. We refer to an independent report from Brendan Quach, Senior Economist at HoustonKemp, in which he sets out his expert opinion that: ²
- a) the approach taken in the draft decision undermines the objectives and intent of the total operating expenditure regime, the EBSS and the NEL/NER economic regulatory regime; and
 - b) aside from the merits and legality of the AER's approach, the revenue outcomes that occur under the AER's draft decision are not consistent with its stated intention in the draft decision.

Our response to the AER's draft decision is discussed in further detail below, and includes the attached supporting documents:

- a report from our insurance broker, Lockton³;
- the independent expert report from Brendan Quach of HoustonKemp; and
- the legal opinion from the Hon. John Middleton AM KC of DLA Piper.

List of supporting attachments

Additional information provided in support of JEN's revised regulatory proposal for insurance premiums is outlined in Table OV–1.

Table OV–1: Additional documents supporting this submission

Reference	Document title	Author
06-01	Operating expenditure and step changes	JEN
06-06	John Middleton Legal Opinion for Victorian DNSP Insurance Opex	DLA Piper
06-07	Victorian DNSP insurance premiums	HoustonKemp
06-08	Insurance premium forecast for 2026-31 and retrospective forecast for 2021-26	Lockton
06-03M	SCS Opex model	JEN
07-01	Incentive schemes	JEN
08-09M	EBSS model	JEN

² HoustonKemp, JEN - RP - Att 06-07 HoustonKemp Victorian DNSP insurance premiums - 20251128

³ Lockton, JEN - RP - Att 06-08 Lockton Insurance premium forecast 2026-31 and retrospective forecast 2021-26 - 20251125

1. Background

1.1 Insurance premiums in 2021–2026

In our 2021–2026 distribution determination, the AER included a step change of \$28.2 million (Real \$2021). This step change was based on forecasts from our insurance broker, Aon, which anticipated a material increase in premiums in the 2021–2026 regulatory period, compared to the previous regulatory period.⁴

The AER acknowledged that there was some uncertainty associated with forecasting insurance premium increases, but ultimately used the forecasts to include an operating expenditure step change for insurance premiums in its final decision. The AER noted that it considered the long-term interests of consumers are better served if the appropriate incentives remain with the businesses to actively work to moderate expected increases in insurance premiums over the next regulatory control period.⁵

The AER rejected a nominated pass-through event for insurance premiums, which would have provided greater flexibility in respect of our recovery of insurance premiums, and in the event that actual costs were different to forecast.

We now have visibility of our actual spend in each year of the 2021 – 2026 regulatory period (noting that final year costs are currently an estimate). Our actual spend on insurance premiums over the 2021 – 2026 regulatory period is lower than the forecasts reflected in our 2021 - 2026 distribution determination. There are a range of reasons for this underspend, as identified by our insurance broker in its attached report.

1.2 Insurance premiums in our 2026–2031 regulatory proposal

We did not propose a step change for insurance premiums in our initial regulatory proposal for the 2026–2031 regulatory period. Our proposed insurance costs were equal to our actual insurance-related operating expenditure in the base year 2024-25, adjusted to provide an estimate of operating expenditure for the final year (2025-26) of the current regulatory period, and then trended forward to the next regulatory period by applying the rate of change.

⁴ AON, JEN - AON Att 06-06 Insurance premium forecast report - 20200131 - Confidential

⁵ AER - Final decision - Jemena distribution determination 2021–26 - Attachment 6 - Operating expenditure - April 2021, Pg. 50

2. AER Draft Decision

In its draft decision, the AER proposed three adjustments relating to our insurance premiums, as follows:

- a non-recurrent efficiency gain of \$24.5 million (Real \$2026) is included in base year operating expenditure, which increases our operating expenditure allowance in each year of the 2026–2031 period in an amount equal to our underspend on insurance premiums in the base year 2024-25 (i.e. the premium allowance in the base year less actual insurance premiums);
- a negative step change adjustment of -\$27.2 million (Real \$2026), calculated as the difference between the allowed and actual premium in the final year (2025-26), that decreases our operating expenditure allowance in each year of the 2026–2031 period; and
- an adjustment to the calculation of the EBSS carryover amounts of -\$24.5 million (Real \$2026) arising from the application of the EBSS during the current regulatory period to reflect the non-recurrent efficiency gain adjustment made to base operating expenditure.

We understand that these adjustments are intended by the AER to:

- ensure the AER's alternative estimate of total forecast operating expenditure satisfies the operating expenditure criteria set out in clause 6.5.6(c) of the NER, by setting a forecast operating expenditure allowance equal to that required by a prudent operator;
- remove the expected difference between actual and forecast insurance premiums in the final year, so ensuring this difference does not carry over into the forecast operating expenditure for the next regulatory period; and
- return all the insurance premium underspends over the 2021–2026 period to customers through EBSS decrements 6 years later, in a manner consistent with all insurance underspends over the 2021 - 2026 period being non-recurrent efficiency gains, while ensuring we retain our share of insurance premiums underspends in the form of the time value of holding the underspends for 6 years.

The AER stated (at page 37 of its operating expenditure draft decision):

To remove the insurance premium component of the final year increment, our alternative estimate for the draft decision includes a combination of a negative insurance step change, and a non-recurrent efficiency gain. This ensures our alternative estimate of total forecast opex meets the opex criteria, and that the EBSS provides a fair sharing of efficiency gains and losses between network businesses and network users.

The negative step change, calculated as the difference between the final year premium allowance and the actual premium, removes the expected over forecasting of insurance premiums in 2025 – 2026, thus ensuring this over forecasting doesn't continue into the 2026 – 2031 period. It then sets the non-recurrent efficiency gain in the base year equal to the insurance underspend in the base year. Together, this results in:

- *Forecast opex equal to that required by a prudent operator*
- *Jemena returning all the 2021 – 2026 insurance premium underspends through EBSS decrements 6 years later (treating the underspends as non-recurrent efficiency gains).*

3. Revised Regulatory Proposal

3.1 Summary of revised regulatory proposal

Our revised regulatory proposal does not accept the AER's draft decision in respect of insurance premiums. Rather, we retain the approach to determining forecast operating expenditure in our initial regulatory proposal through a standard base-step-trend approach, and remove the adjustment of non-recurrent efficiency gain in both operating expenditure and EBSS.

Our revised regulatory proposal is informed by an independent expert report from HoustonKemp, a legal opinion from the Hon. John Middleton AM KC, and a report from our insurance broker. These documents are discussed further below, and support our position that the AER's approach in its draft decision should not be reflected in its final decision.

3.2 Insurance broker report

We attach a report from our insurance broker, Lockton as *Attachment 06-08*. This report provides a forecast of our insurance premiums for the next regulatory period, which supports the proposition that we are able to sustain the underspend on insurance premiums incurred in our base year. The underspends do not reflect a temporary or one-off reduction in our expenditure on insurance premiums.

Further, this report details the measures that we have taken to reduce our insurance premiums in the current regulatory period, and confirms that these measures contributed to our insurance underspends in the current regulatory period, a consideration that the AER did not take into account in its draft decision.

In particular, JEN has implemented the following measures to reduce insurance costs:

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Without these initiatives, JEN's insurance premiums would have been significantly higher, as noted in Lockton's report.

3.3 HoustonKemp's report

Brendan Quach, Senior Economist at HoustonKemp, was engaged on behalf of AusNet, JEN, Powercor and United Energy (the **Victorian DNSPs**) to prepare an independent report setting out his expert opinion on the AER's decision, including an assessment of:

1. the approach the AER purports to have taken to determining the Victorian DNSPs' insurance operating expenditure in the draft decision, and whether the outcomes under the draft decision are consistent with the AER's stated intention; and
2. the merits of the AER's stated approach as set out in the draft decisions.

A summary of HoustonKemp's key findings on the merits of the AER's approach is set out below. The full report is provided as *Attachment 06-07*.

The AER's approach ignores any efficient cost management by the DNSPs

The AER's draft decision implicitly attributes the Victorian DNSPs' insurance premium underspends to external factors outside of the control of the businesses, and not the result, in whole or in part, of the DNSPs' efforts to manage insurance premium costs.

The failure to recognise and reward the DNSPs' efforts to manage costs undermines regulatory incentives, and encourages the businesses not to make any effort to mitigate cost increases, by introducing the risk that these efforts will be 'clawed back' in setting revenue allowances in subsequent regulatory determinations.

HoustonKemp points to a series of measures undertaken by each of the Victorian DNSPs to mitigate insurance costs over the current regulatory period.

The AER's approach undermines the objective and intent of the regulatory regime

The AER's approach undermines the objective and intent of the regulatory regime. In particular:

- the AER's adjustments are inconsistent with the intent of the EBSS;
- the use of ex-post adjustments for ex-ante forecasting inaccuracies undermines the incentives regime;
- the AER's approach does not allow for reasonable cost recovery;
- the draft decisions undermine the total operating expenditure regime; and
- the draft decisions do not provide for a fair sharing of temporary efficiency gains.

The AER's adjustments are inconsistent with the intent of the EBSS

The non-recurrent efficiency gain mechanism was introduced into the EBSS to deal with circumstances where a DNSP experiences efficiency gains in the base year that are in the nature of a reduced level of actual operating expenditure that will not persist into the future. If, in calculating base year operating expenditure, the amount of such gains is not included, then this would result in an operating expenditure allowance that did not reflect the DNSP's expected efficient operating costs over the forthcoming regulatory period. The intention of the non-recurrent efficiency gain mechanism was to change the optics of the operating expenditure decision but not its revenue outcome.

In the draft decisions, the AER's non-recurrent efficiency adjustment mechanism:

- did not reflect a finding that actual insurance costs in the base year would not persist into the future;
- was intended to remove the insurance premium component of the final year increment; and

- in combination with the negative step change, effected a material reduction to the DNSP's allowed revenue, rather than merely changing the optics of the decision.

Accordingly, the AER's adjustments are inconsistent with the intent of the EBSS.

The use of ex post adjustments for ex ante forecasting 'errors' undermines the incentives regime

The AER's reasoning in its draft decisions suggests that it is seeking to make a retrospective adjustment for overestimating insurance premium increases in the current regulatory period. This ex-post clawback of insurance premiums in the current regulatory period is inconsistent with the ex-ante regulatory framework, under which DNSPs are encouraged to reduce costs to retain any difference between actual costs and forecast costs (or to wear the financial penalty when forecast costs are lower than actual costs).

In making its 2021–2026 final decisions, the AER observed that there was some uncertainty associated with forecasting insurance costs for the current regulatory period. However, the AER found that, on balance, the long-term interests of consumers are better served if the appropriate incentives remain with the businesses to actively work to moderate expected increases in insurance premiums over the regulatory period.

In other words, despite the uncertainty of future insurance premiums, the AER affirmed at the beginning of the current regulatory period that:

- the usual incentives regime would apply to insurance costs; and
- the Victorian DNSPs would be:
 - rewarded if their operating costs were lower than implicit allowance; and
 - penalised if their operating costs were higher than forecast.

Thus, the AER's decision to claw back past insurance gains:

- is inconsistent with the forecast operating expenditure and EBSS provisions in the NER, which do not allow for retrospective adjustments for a DNSP's past gains or losses;
- is inconsistent with the stated rationale for, and objectives of, the AER's 2021 – 2026 final decisions, which acknowledged the uncertainty of forecasting insurance premiums for that regulatory period, but ultimately determined it was appropriate to accept those forecasts and have the incentives regime apply, in order to deliver incentives for the Victorian DNSPs to outperform those forecasts; and
- undermines the regulatory ex ante incentives, as DNSPs will no longer have the certainty they will be rewarded for outperforming their operating expenditure allowance.

The AER's approach does not allow for reasonable cost recovery

The AER has retrospectively reclassified insurance cost outperformance as temporary, without establishing a clear principle for when material variances between actual and forecast costs will be treated as temporary. In particular, the AER does not specify whether it will reclassify expenditure that was materially higher than forecast as a temporary efficiency loss.

A regulatory framework that can retrospectively lower the rewards for outperformance but does not retrospectively lower the penalties for underperformance introduces a downward bias in outcomes. In other words, the expected value of the incentive mechanism decreases, with the effect that DNSPs are not provided with a reasonable opportunity to recover their efficient costs.

The draft decisions undermine the total operating expenditure regime

The NER requires DNSPs to propose the total forecast operating expenditure required to achieve the operating expenditure objectives for the regulatory period. The AER must accept a DNSP's operating expenditure forecast if it is satisfied that the total operating expenditure forecast for the regulatory period reasonably reflects the

operating expenditure criteria. In other words, the AER is required to form a view on total operating expenditure for the forthcoming regulatory period, rather than on subcomponents such as individual projects or programs.

As a consequence, DNSPs receive a total operating expenditure allowance, rather than several allowances for different subcomponents such as individual projects or programs. This tacitly accepts that there is uncertainty in forecasting individual operating expenditure subcomponent costs and, while for some operating expenditure subcomponents costs may be higher than forecast, for others they will be lower than forecast.

The AER's draft decision effectively establishes a subcomponent allowance for insurance costs specifically, which:

- ignores the uncertainty of forecasting costs for individual operating expenditure subcomponents and that DNSPs will outperform on some operating expenditure subcomponents but underperform on others, but must manage their overall operating expenditure within their budget; and
- diminishes the incentives DNSPs have to efficiently reduce costs.

Incentives are diminished because DNSPs will be disincentivised from managing their risk/efficiency as a whole. For example, insurance premium costs are interrelated with bushfire mitigation costs. Instituting an allowance for the insurance subcomponent will mean that a DNSP will be hesitant to reduce bushfire insurance costs by investing in mitigation measures, through incurring additional costs on the bushfire mitigation subcomponent, even when it is efficient to do so. DNSPs will fear that the expected benefits of reducing their insurance costs may be lost while also bearing the full cost of the other mitigation measures and any associated underperformance of their operating expenditure allowances.

The draft decision does not provide for a fair sharing of temporary efficiency gains

HoustonKemp has determined what a fair sharing of efficiency gains would look like, in circumstances where our insurance underspends in the current regulatory period are treated as temporary (i.e. putting aside the fact that our insurance underspends cannot properly be characterised as a non-recurrent efficiency gain).

The financial impacts of the draft decisions are inconsistent with the AER's stated objective of treating insurance outperformance as a temporary efficiency gain. As a result, the AER's draft decision does not provide for a fair sharing of efficiency gains, even where the insurance underspend is treated as temporary. Rather, the Victorian DNSPs are penalised for their underspends by the AER's adjustments in the draft decisions, in circumstances where HoustonKemp has determined that they should have received some reward if the EBSS's treatment of temporary efficiency gains were applied to them in the manner contemplated by the AER's stated reasons for decision.

3.4 Legal opinion

The Victorian DNSPs engaged the Hon. John Middleton AM KC to consider the legality of the AER's approach to assessing our insurance premiums, as set out in its draft decision. The opinion identified four legal issues with the AER's approach, each of which, of itself, has the effect that the AER's approach is unlawful. These are summarised below, and the full opinion is provided as *Attachment 06-06*.

Issue 1: The AER's draft decisions to treat insurance premium underspends as a non-recurrent efficiency gain are not authorised by the NER

The NER provides that the AER must, as part of its final distribution determination for a DNSP, specify how the EBSS will apply to the DNSP in the forthcoming regulatory period. The AER's decision on the application of the EBSS is binding; the NER does not permit the retrospective amendment of the operation of the EBSS at the end of a regulatory period, for the purposes of calculating EBSS carryover amounts. This is well established, and has been accepted by the AER previously.

The AER's draft decisions treat the Victorian DNSPs' insurance premium underspends in their respective base years as a 'non-recurrent efficiency gain', used in combination with a negative step change, to 'clawback' the Victorian DNSPs' underspend on insurance premiums in the current regulatory period. The Version 2 EBSS does

not define the term 'non-recurrent efficiency gain', nor does it provide any meaningful commentary on what that term means, and how it should be applied.

However, further detail is found in the AER's accompanying Explanatory Statement, where non-recurrent efficiency gains are discussed under the heading 'one-off factors in the base year'. In particular, the Explanatory Statement provides that:⁶

- expenditure should be treated as a non-recurrent efficiency gain in circumstances where a DNSP cannot sustain the level of expenditure that it incurred in the base year, as a result of a one-off factor that led to an underspend relative to forecast operating expenditure in that base year; and
- the purpose of the non-recurrent efficiency gain adjustment is to enable revenue to be shifted from the EBSS carryover to the operating expenditure allowance, rather than to effect a reduction in overall allowed revenue.

It is clear from the Explanatory Statement that the AER is permitted by the Version 2 EBSS, and thus the NER, to treat an operating expenditure underspend in the base year as a non-recurrent efficiency gain in limited circumstances, and that DNSPs should not be left worse off in their total revenue allowance as a result of any base year non-recurrent efficiency gain. The EBSS does not provide for the non-recurrent efficiency gain concept to be used as a mechanism to recover operating expenditure underspends from DNSPs. Nor was any provision made by the AER's decision on how the Version 2 EBSS was to apply to the Victorian DNSPs in the current regulatory period, for any supplementary or expanded use of this non-recurrent efficiency gain concept.

The AER's three step approach to assessing insurance premiums is not authorised by the Version 2 EBSS or the NER. This is because:

- the insurance premium underspend in the base year cannot properly be characterised as a non-recurrent efficiency gain in that year. The underspend did not occur only in the base year, as a result of a one-off factor. Each Victorian DNSP underspent in multiple years of the regulatory period, and they are able to sustain this reduced level of expenditure going forward;⁷ and
- by treating the insurance premiums underspend in the base year as a non-recurrent efficiency gain, in combination with a negative step change, the AER is not merely shifting revenue from the EBSS carryover to the operating expenditure allowance. Rather, the AER is reducing the Victorian DNSPs' overall revenue allowance. This is demonstrated in HoustonKemp's report.

On this basis, the AER's draft decisions make an adjustment to the calculation of the EBSS negative carryover amounts for the 2026–2031 regulatory period that the AER does not have the power to make. The AER is bound to apply the Version 2 EBSS when calculating the Victorian DNSPs' EBSS carryover amounts for that regulatory period. The AER has not followed the Version 2 EBSS, as applied by its distribution determinations for the current regulatory period, when calculating the Victorian DNSPs' carryover amounts, as it purports to make adjustments which are outside the scope of the Version 2 EBSS, and are not provided for in those distribution determinations in applying that EBSS in the current regulatory period.

Issue 2: The AER's draft decisions are contrary to the scheme of the NEL and NER

The Chapter 6 economic regulatory regime is an incentives based, ex ante regime. Under this regime, DNSPs are not guaranteed to recover their actual costs of providing direct control services, rather, they are remunerated in respect of their forecast costs. As DNSPs are able to keep a proportion of the benefits of any unanticipated cost reductions (relative to forecast) that occur during a regulatory period, they are incentivised to make cost savings and incur only their efficient costs. The converse of this is that DNSPs must also absorb a proportion of unanticipated cost increases.

Together, clauses 6.5.6 and 6.4.3 of the NER give effect to these principles in respect of operating expenditure. Neither clause 6.5.6 nor clause 6.4.3 provides for the AER to revisit operating expenditure incurred in a previous

⁶ AER, *AER explanatory statement – efficiency benefit sharing scheme*, November 2013, at p. 20.

⁷ Lockton, *JEN - RP - Att 06-08 Lockton Insurance premium forecast 2026-31 and retrospective forecast 2021-26 – 20251125*.

regulatory period, other than for the purposes of calculating any revenue increments or decrements arising from the application of a relevant scheme (including the EBSS) or a control mechanism.

The Australian Competition Tribunal has recognised that this is the way in which the regulatory regime operates (in *Application by EnergyAustralia and Others* [2009] ACompT8). In particular, the Tribunal observed that, generally, no adjustment is made to revenue after the event to reflect changed circumstances.⁸

The AER's draft decisions:

- effectively 'clawback' the Victorian DNSPs' underspend on insurance premiums in the current regulatory period, relative to the forecast determined at the outset of that regulatory period; and
- as a result, are inconsistent with the scheme of the NER, being that of incentive based, ex ante regulation. The AER's decisions seek to ensure that the Victorian DNSPs are only able to recover their actual costs for insurance premiums.

Issue 3: The AER's draft decisions contravene section 16(1) of the NEL

Section 16(1) of the NEL requires the AER to, in performing or exercising an AER economic regulatory function or power, perform or exercise that function or power in a manner that will or is likely to contribute to the achievement of the NEO. The AER's making of a distribution determination is an 'AER economic regulatory function or power'.

Section 7A of the NEL sets out the revenue and pricing principles. The Australian Competition Tribunal has recognised that a decision which is inconsistent with the revenue and pricing principles cannot be a decision that will or is likely to contribute to the achievement of the NEO.⁹ Relevantly, the revenue and pricing principles provide that a regulated network service provider should be provided with:

- a reasonable opportunity to recover at least the efficient costs the operator incurs in providing direct control services, and complying with a regulatory obligation or requirement or making a regulatory payment; and
- effective incentives in order to promote economic efficiency with respect to direct control services the operator provides.¹⁰

The AER's draft decisions, if finalised, will:

- not provide the Victorian DNSPs with a reasonable opportunity to recover at least the efficient costs they incur in providing direct control services; and
- have the effect of distorting the Victorian DNSPs' incentives to provide their direct control services in a manner that promotes economic efficiency,

as described in the HoustonKemp report.

It is clear, from the HoustonKemp report, that the AER's draft decisions are inconsistent with the revenue and pricing principles, as they do not provide the Victorian DNSPs with a reasonable opportunity to recover their efficient costs, or an effective incentive to promote economic efficiency when providing direct control services. Accordingly, consistent with the Australian Competition Tribunal's previous decisions, the AER's draft decision cannot be a decision that will or is likely to contribute to the achievement of the NEO. As a result, the AER's decisions contravene section 16(1) of the NEL.

Issue 4: The reasoning of, and rationale for, the AER's draft decision, is unreasonable

⁸ *Application by EnergyAustralia and Others* [2009] ACompT8 at [77] – [78] (own emphasis added).

⁹ *Re Application by ElectraNet Pty Limited (No 3)* [2008] ACompT 3 at [15].

¹⁰ National Electricity Law, Section 7A(2).

For the reasons set out in the independent report of HoustonKemp, the reasoning and rationale for the AER's draft decisions are unreasonable and not rational.

3.5 Insurance premiums in revised regulatory proposal

For the reasons set out above, our revised regulatory proposal does not accept the AER's draft decision in respect of insurance premiums. Rather, we retain the approach to forecasting operating expenditure, including for insurance premiums, for the next regulatory period by including the actual insurance premium in the base year operating expenditure, without further adjustments, in our operating expenditure forecast for the next regulatory period. We have also removed the adjustment for non-recurrent efficiency gain in our EBSS calculation.

In particular, we consider that the AER's draft approach should not be reflected in its final decision, rather, a standard base-step-trend approach should be used to forecast operating expenditure, including for insurance premiums, without the AER's proposed adjustments outlined above.